

APPENDIX

Notes for FOMC Meeting
August 14, 1979

Scott E. Pardee

In the first two weeks following the last FOMC meeting, the dollar came under repeated bouts of selling pressure, as the exchange market reacted negatively, first to the delay of President Carter's energy address, then to the address itself, then to the resignation of his cabinet, then to the list of names of those who were asked not to stay on, and then to statements by Treasury Secretary designate Miller and by President Carter effectively ruling out a new program to help the dollar. During that stretch, which was not seen so much as one of economic crisis as a crisis in leadership, the U. S. authorities acted vigorously to stave off what could have been a real rout for the dollar. On behalf of the Federal Reserve and the Treasury the Desk intervened extremely forcefully in the market, virtually around the clock, selling \$2.5 billion of marks, of which \$1.1 billion was in the Far East. In addition, the Federal Reserve raised the discount rate and the Federal funds rate on July 19. These actions helped, and the pressures on the dollar lifted in late July, particularly after Mr. Volcker was named the next Chairman of the Federal Reserve. It's fair to say that not only was Chairman Volcker's appointment welcomed in the market, but so were the things he said in press conferences and at the Senate confirmation hearings on curbing inflation, on the need for a stable dollar, and on maintaining the independence of the Federal Reserve.

Dollar rates were somewhat firmer in very quiet trading in early August, and we did not intervene again for ten trading days. Selling pressure emerged again last Friday, however, following poor producer price figures for the United States. We sold \$250 million of marks, split evenly between the System and the Treasury. The dollar has firmed somewhat yesterday and today, which helped calm the market again.

Even though the selling pressures have eased off in August, we have seen little reflux of funds back into the dollar. Almost everyone we talk to outlines a pretty bleak scenario for the dollar, reflecting varying degrees of disgruntlement over the performance of the President, over the attitudes of members of the White House staff, over what many consider the inability of the Administration to shape a coherent economic policy and get it through Congress, and over what appears to be the continuing chaotic state of energy policy. This is intensely personal stuff and yet it becomes translated into an unwillingness to believe that the dollar is going anywhere but down.

Before the November 1 program last fall, I characterized the shift in the market's mood from one of skepticism to one of cynicism, and I'm afraid that cynicism is surfacing again. It is reinforced this time by the market's belief that European central banks, and in particular the Bundesbank, are not prepared to buck heavy selling pressures on the dollar. Those countries have also had a heavy jolt of inflation; and the central banks, through several rounds each of interest rate hikes, have showed that they are prepared to use monetary policy vigorously to counter the effects of external price rises,

such as the oil price, on their domestic economies. In intervention policy at least, the Bundesbank has been helpful, with some timely purchases of dollars when the dollar/mark rate has approached the 1.80 level. Moreover, Bundesbank officials have not, as yet, uttered a word of complaint about the domestic liquidity effects of our own heavy sales of marks.

I might add that there is still a great deal of talk in the market of a new package of measures, to achieve the same kind of dramatic effects of last November 1. People are not sure, however, what would be in such a package, and some of the pessimism around reflects the recognition that it would be difficult to put together something credible.

At the same time, some accept the plausibility of a more favorable medium-term scenario. In this, the economic slowdown here at a time of continuing growth abroad would lead to a dramatic improvement in the U. S. trade and current accounts. That turnaround, coupled with continuing monetary restraint here to avoid short-term capital outflows, could give a strong underpinning to the dollar later this year and in 1980. This scenario is close to official thinking, but few in the markets are willing to bet on it for the moment.

On operations, we have taken opportunities this month to liquidate some \$150 million equivalent of mark swap debt, so that our net increase in drawings on the Bundesbank amounted to \$1,143 million, leaving current drawings at \$2,048 million. Also, we paid off our \$32 million of Swiss franc debt to the Swiss National Bank at a modest profit.

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement:

Since the July 11 meeting of the Committee, the Account Management has encouraged a gradual firming of money market conditions in response to strengthening aggregates and a weakening dollar. For about the first week of the period the Desk continued to aim for the 10 1/4 percent Federal funds rate that was sought since late April. By July 20, with Board staff estimates suggesting monetary growth at or slightly above the tops of the Committee's ranges, and the dollar faltering amid uncertainties about U.S. energy policy and shifts in key cabinet positions, the Desk began, after Committee discussion, to seek a funds rate around 10 1/2 percent, the top of the range adopted at the July meeting. The move coincided with the announcement of a 1/2 percent increase in the discount rate, to 10 percent. Initially, to give greater force to the move and be as helpful as possible to the dollar, the Desk sought a "relatively firm" 10 1/2 percent funds rate. A week later, July 27, estimates of aggregate growth had strengthened somewhat further, while the dollar had steadied partly in reaction to news of Mr. Volcker's nomination as Chairman. In view of the strong aggregates, the Committee voted to raise the upper limit

of the funds range to 10 3/4 percent, instructing the Manager to aim in a 10 1/2 - 10 3/4 percent range, depending on further developments with the aggregates and with the dollar. The Desk then began seeking a funds rate around 10 5/8 percent. The next bit of data on the aggregates appeared a trifle weaker, while the dollar was holding its own and the objective accordingly remained at 10 5/8 percent into the first full week of August. By last Friday, however, the latest information on aggregates was slightly stronger again while the dollar was once more under pressure following publication of a bad price number for July. Accordingly, the Desk adjusted its objective slightly further to aim for a funds rate of 10 5/8 percent or a shade higher.

In practice, the funds rate often tended to exceed the Desk's objective, in part because of fairly persistent shortages of securities available for repurchase agreements. Also, in a period of gradual firming there was some tendency for market participants to overanticipate, and carry the firming a bit beyond the Desk's intention of the moment. For the whole period, the funds rate averaged about 10.62 percent, up 33 basis points from the previous intermeeting interval. Before last Friday's further slight firming move, market participants seemed to be pretty well agreed that the System's objective was 10 5/8 percent, even though the weekly averages had been coming in a bit higher. At present, there is some market uncertainty about the Desk's objective--where it is and where it is going. Some think that the System is already aiming at 10 3/4 percent; others

would place the objective slightly lower but on the way to that level, or perhaps higher. Still others are not sure that we have really changed from 10 5/8 percent.

There were large reserve needs during the period because of increased required reserves, lower float, lower holdings of foreign currency, and a decline in member bank borrowings. Reserves were supplied through outright purchase of \$850 million of Treasury bills in the market the day of the last meeting, net purchases of \$1,167 million of bills from foreign accounts, \$482 million of agency issues in the market, and yesterday about \$975 million of Treasury coupon issues for delivery today and tomorrow. This is a substantial grand total of roughly \$3 1/2 billion in outright purchases, but this did not violate our intrameeting leeway because it includes bill purchases on the day of the last meeting, which came under the previous leeway. There was also substantial use of repurchase agreements on most days, and matched sale-purchase transactions to absorb reserves on a few days.

Most short-term rates rose about 15 to 50 basis points over the interval, with the larger increases about in line with the boost in the funds rate. Treasury bills rose somewhat less in rate than most other short paper, as bills were in demand from foreign central banks, and from the Desk for RP collateral. Three- and six-month bills were auctioned yesterday at average rates of about 9.50 and 9.48 percent, compared with 9.27 and 9.16 percent shortly before the last meeting.

Rate rises for some Treasury coupon issues maturing in around a year were as much as 55 basis points, but for 2- to 10-year issues the increases were mainly about 10-30 basis points. For the longest issues most yields were a more moderate 7 to 10 basis points higher, as some encouragement was taken that the central bank, under its new leadership, would show strengthened resolve to combat inflation. This view also helped elicit a good response to the Treasury refunding issues, which in turn tended to buoy general market sentiment. In the refunding, the Treasury raised about \$2.4 billion in new money through the sale of \$7 1/4 billion of 3-year, 7 1/2-year, and 30-year issues at rates of 9.06, 9.00 and 8.91 percent, respectively. The two shorter issues soon rose to moderate premiums in secondary market trading although these gains faded by the end of the period amid new concern about inflation and the dollar. The long bond, which was bid for after the market had already risen in price, traded close to issue price for a time, and then slipped to a discount at the end of the period. The dealers have made reasonably good progress in distributing their awards of the new issues, especially of the long bond. The System's coupon purchases yesterday provided a further opportunity to make sales. Altogether, dealer holdings of over-one-year issues came down to about \$465 million by last Friday, from a high of about \$1.1 billion after the bond auction. This compares with a net short of about \$500 million just before the last meeting. In coming weeks, new Treasury financing may well include a 5-year note and a cash management bill in addition to rollovers of maturing issues.

In recent days we have sought to monitor development closely in the commercial paper market, to see whether Chrysler's difficulties are having any impact comparable to the situation in 1970 when Penn Central's failure caused many investors to pull away from the paper market. Today, we see nothing comparable to the earlier experience. Chrysler Financial Corp. has had to repay some \$700 million in commercial paper in recent days, and has drawn on bank lines, but there has been little or no discernible effect on other paper issuers. No significant change is reported in rate spreads between top-grade and lesser issuers.

Joseph S. Zeisel
August 14, 1979

FOMC BRIEFING

Available information continues to suggest a further weakening of the economy over the balance of this year. An easing of gas supplies may currently be permitting some rebound in activities that were constrained by fuel shortages. However, the fundamental factors which have been damping growth all year are still operating to slow overall activity, and the economy will be digesting the effects of the recent OPEC price hikes for some time to come.

The major factor in the 3-1/3 percent annual rate decline of real GNP in the second quarter was the sharp drop in personal consumption expenditures. Much of this weakness represented the collapse of large car sales in response to uncertainties regarding fuel availability. But transitory considerations aside, the fundamentals underlying consumption have been weak for some time, particularly real personal income growth. And the principal forces supporting income gains--production and employment--show signs of continued deterioration.

Industrial production appears to have edged down further in July to only fractionally above its level last December. Last month's decline reflected a reduction in output of autos and other consumer goods as well as trucks. But auto assemblies were still at an 8.8 million rate in July, down only 3 percent from June, and well in excess of the rate of sales. Industry schedules have now been trimmed sharply further to a 7.3 million unit rate in August. Other things being equal, such a cut in production of autos and parts would have the effect of reducing the industrial production index from $1\frac{1}{2}$ - $3\frac{3}{4}$ percent this month.

As a result of the sluggishness of economic activity, demand for labor has weakened perceptibly in recent months. Although the overall unemployment rate has changed little, nonfarm payroll employment figures show an increase of only 30,000 jobs in July (strike adjusted), as compared to an average monthly gain of 160,000 over the second quarter, which itself was only half the monthly rise during the first quarter. Manufacturing employment dropped in July for the fourth month in a row to a level 130,000 below its March peak.

With employment conditions weakening and prices continuing up sharply, real personal income declined in June, for the fifth time in six months, to

a level more than 2 percent below its December peak. It is probable that real personal income dropped again in July.

Moreover, consumer attitudes are reported to have deteriorated further recently. Both the Michigan and Conference Board surveys indicate consumer confidence to be at the lowest level since the 1974-75 recession.

Reflecting these factors, consumer demand has remained sluggish. Total retail sales increased only four-tenths of 1 percent in July, and although the figures for May and June were revised up, in real terms last month's retail sales total was about 5-1/2 percent below the year-end level.

The drop in auto sales contributed substantially to this decline. Demand for cars already had begun to weaken in the April-May period, undoubtedly largely the result of reduced real income and heavy debt burdens. When fuel shortages developed, unit sales dropped further in June to a 7-1/4 million rate for domestic models, with particular weakness among the larger gas guzzlers. Unit auto sales picked up in July to an 8.1 million rate--probably in response to price concessions as well as increased availability of fuel. However, this was still 10 percent below the first quarter sales rate, and well under the rate of production. As a result, already large dealers' stocks rose further, particularly for the less fuel-efficient models.

In addition to the buildup of unsold cars in dealers' hands, there was a relatively rapid accumulation of total manufacturers' inventories through the end of the second quarter. For the quarter as a whole, manufacturers' stocks in book value terms increased at a \$36 billion annual rate-- the largest quarterly advance since the third quarter of 1974. Some of this may have been the result of disruptions to shipments due to fuel shortages and protests by independent truckers. And while inventory ratios generally are not inordinately high, except for ^{large} autos, we expect downward production adjustments to constrain further stockbuilding, particularly in an environment of weakening demand.

Of course, the outlook for overall activity depends importantly on the performance of capital spending. Business fixed investment in real terms fell in the second quarter as shipments of equipment dropped and truck sales continued the decline that began toward the end of last year. At the same time, nonresidential construction put-in-place remained strong. As far as the future is concerned, while orders for capital equipment recovered some of their previous losses in May and June, the level of such commitments remained below the spring peak, even in current dollar terms. Moreover, business commitments for construction spending also indicate a slackening of demand.

Homebuilding has held up surprisingly well of late, with private starts rising by 6 percent in June to a 1.9 million annual rate. Most of the recent strength has been in the multifamily sector, reflecting both an increased number of HUD subsidized units and continued demand for rental housing--as indicated by the fact that rental vacancy rates are very close to a record low. In contrast, activity in the single-family sector has been relatively stable in recent months at a level well below last year's rate. But the demand for these houses apparently has continued to weaken; sales dropped sharply in June for both new and existing homes and pushed the stock of unsold homes to a 7-1/2 months supply at current sales rates, the largest overhang since March 1975. With financial conditions in mortgage markets relatively tight and mortgage commitments of S&Ls trending down, the outlook continues to be for reduced housing activity for the remainder of this year.

On balance, the staff is still forecasting a decline in real GNP for the current quarter, at a bit under 2 percent. Consumption and business spending may not be quite as weak as in the second quarter, but inventory accumulation should be considerably below last quarter's high rate. We continue to forecast comparatively small quarterly declines in real GNP into

early 1980, reflecting weakness in housing, reduced business outlays for both fixed capital and inventories and quite sluggish consumer demand. In the absence of new fiscal initiatives, government spending will be contributing little to growth over the next year and a half. But short of any substantial further shocks, it appears that economic recovery should begin next spring as housing activity bottoms out in response to underlying demands, business outlays pick up and consumer spending begins to recover as growth in real income resumes. The projected sluggishness of domestic demand relative to growth abroad should also be operating to increase the balance on net exports through the middle of next year. Overall, however, we are still forecasting a very modest rise in real output of less than 1 percent during 1980.

In this environment we would expect a considerable weakening of the demand for labor. Employment adjustments have been quite small so far, as evidenced by the stability of the unemployment rate and the sharp declines in productivity. We project industrial employment to drop substantially over the balance of this year and into early 1980; the service sectors should show further modest growth. We continue to project a rise in the unemployment rate to close to 7 percent by the end of this year and to about 8 percent by the close of 1980.

The price outlook for this year remains bleak, in part because of the poor performance of productivity, but also reflecting the rapid runup of energy prices. The rate of increase in consumer prices in June--1 percent--was about the same as the average earlier this year, despite an easing of food prices, as the energy component of the CPI posted the largest monthly advance on record, 5.6 percent. Energy prices are expected to continue up at a rapid clip for the balance of the year, since only part of the large OPEC price rise has as yet passed through domestic markets. The sharp July increase of 1.1 percent in producer prices reflected in part a substantial increase in the price of energy.

But for 1980, we continue to feel that the combination of weaker markets, a resumption of productivity growth, and an assumed moderation of energy price increases will result in some easing of the rate of inflation. However, the process of getting inflation under control is likely to be lengthy, and we are still forecasting a rate of increase in the fixed-weighted gross business product price index of about 8-1/2 percent in the last quarter of 1980.

While the staff has projected a slowing of M-1 growth over the August-September period compared with the rapid expansion of the previous four months, the August-September projection remains high relative to the Committee's longer-run target. With the funds rate at about the current level, M-1 growth is projected to be at a 7 percent annual rate, which translates to about 8 percent after adding back ATS effects. Similarly, M-2 growth for the two-month period is projected to be high relative to its longer-run range. If these projections prove out, M-1 by September would be in the upper half of its adjusted longer-run range, as shown in the bottom panel of the chart on page 10 of the blue book, and M-2 close to the upper limit of its longer-run range.

Despite these recent developments, staff analysis indicates that the Committee might well hit its longer-run aggregate targets for 1979 without any further rise of interest rates--indeed with some decline. But this requires a very substantial deceleration in money growth in the fourth quarter. There are two main reasons for expecting this to occur. One is the continued weakness projected for real economic activity over the balance of the year. The second is the view that the recent build-up in cash balances--both demand and savings deposits--is in part temporary, reflecting economic uncertainties associated with the energy crisis, and will not last.

A very brief review of money supply developments since November may be helpful in evaluating recent and prospective tendencies. Starting in the fall of last year and continuing through this winter the demand for M-1 clearly shifted downward relative to income and interest rates, as compared with past historical experience. This downward shift followed the introduction of ATS accounts in November and the coincidental rise

of market interest rates stemming from policy actions in connection with the dollar support program--all of which jolted the public into even greater recognition of the relatively high cost of idle cash balances, including savings deposits.

The main question at the time was how long would the downward shift last. The staff felt that it would be much shorter than the about two-year downward shift that followed the interest rate peak of 1973-74 and ensuing changes in money technology. On superficial analysis, the recent downward shift might seem to be about over already. Our quarterly econometric model shows no shift in the second quarter and there probably will be none in the third--both quarters of negative income velocity of M-1. However, interpretation is made difficult by the summer energy crisis. Savings deposits at banks, after contracting since last fall, begin expanding rather rapidly in June and the expansion has continued thus far for three months. M-1 growth has also been relatively rapid over that period. These developments could reflect mainly a temporary, precautionary response to the sudden intensification of economic uncertainties, as noted earlier. And to the extent that they do, they should soon be reversed as demand deposits above current transactions needs and savings deposits above normal precautionary needs are moved into other higher-yielding investments.

The preceding analysis suggests why with some reasonable degree of probability the relatively high 2-month August-September ranges for the aggregates projected in the blue book may be followed by slower growth in the fall and thus may be consistent with the Committee's longer-run targets. But after reversal of whatever part of the recent cash build-up

is temporary, it is still highly uncertain whether underlying money demand will be weak because the earlier downward shift re-emerges in some degree, or whether underlying money demand will be strong because normal historical relationships reassert themselves. Our staff projections for the fourth quarter of this year--and incidentally for 1980--assume that a downward shift in money demand re-emerges, though a less marked one than earlier this year. Without such a shift the Committee might still hit the 1979 longer-run target for M-1 after appropriate ATS adjustment and also its M-2 target, but growth would be in the upper half of the ranges, or possibly above the upper limit depending in part on near-term interest rate developments. Thus, failure of a downward demand shift to emerge later this year could bring into question either the attainability of the Committee's longer-run monetary targets or the viability of the staff's interest rate in GNP forecasts.

However that may be, there are still immediate reasons that the Committee may wish to consider for adjusting the current two-month August-September blue book projections for the aggregates to tilt the odds more toward-attaining longer-run targets. This could involve a downward adjustment into instructions for guiding the Desk. Three arguments might be advanced for such an approach. One is prudential: when the level of money is in the upper half of the longer-run range, two-month growth rates might best be relatively moderate so as to increase the odds of achieving that range. A second argument relates to possible direct impacts on the economy: the build-up in cash balances, though temporary, may lead to stronger inflationary pressures than projected because the balances could end up being spent on goods and services rather than being shifted to other financial assets. A third argument relates to effects on market psychology: continued relatively rapid growth of the aggregates without a further sign

of response by the System would further weaken the dollar on exchange markets and would erode efforts to dampen inflationary psychology domestically.